

ANALYSIS OF ORIGINAL BILL

Franchise Tax Board

Author: Brulte, et al Analyst: Kimberly Pantoja Bill Number: SB 782
Related Bills: See Legislative History Telephone: 845-4786 Introduced Date: 02/23/2001
Attorney: Patrick Kusiak Sponsor: _____

SUBJECT: Scholarshare Trust Refundable Credit

SUMMARY

This bill would establish a refundable tax credit of up to \$500 for contributions to Scholarshare accounts.

PURPOSE OF THE BILL

According to the author's staff, the intent of this bill is to provide a state tax incentive to encourage families to save for their children's college education through the Scholarshare Program.

EFFECTIVE/OPERATIVE DATE

As a tax levy, this bill would be effective upon enactment and operative with respect to contributions made on or after January 1, 2001.

POSITION

Pending.

Summary of Suggested Amendments

An amendment is provided to address the department's technical concern. Department staff is available to assist with amendments to resolve the implementation and policy concerns described below.

An amendment is suggested to provide appropriation language to fund the departmental costs associated with administering the proposed credit.

ANALYSIS

FEDERAL/STATE LAW

Existing federal law provides that distributions and earnings from a state tuition program are nontaxable to the contributing taxpayer if the account meets the following criteria:

- A. Established and maintained by a state agency or instrumentality under which a person may purchase tuition credits for a designated beneficiary or make contributions to an account established to meet the qualified higher education costs of a designated beneficiary;

Board Position:	Department Director	Date
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	Alan Hunter for GHG	3/30/01

- B. Purchases or contributions may be made only in cash;
- C. A penalty, which is more than de minimis, is imposed on any refund of earnings from the account that is not:
 - 1. used for qualified higher education expenses of the designated beneficiary;
 - 2. made on account of the death or disability of the designated beneficiary; or
 - 3. made on account of a scholarship received by the designated beneficiary to the extent the refund does not exceed the amount of the scholarship used for qualified higher education expenses;
- D. Provides separate accounting for each designated beneficiary;
- E. Provides that contributors and beneficiaries may not, directly or indirectly, dictate the investment of any contribution to the program or earnings thereon;
- F. Does not allow interest in the program to be used as security for a loan;
- G. Prohibits contributions in excess of that necessary to provide for the qualified higher education expenses of the beneficiary, which are defined as tuition, fees, books, supplies, and equipment and reasonable costs for certain room and board; and
- H. Provides for program reporting to the Internal Revenue Service (IRS) of distributions and educational benefits received.

This federal law provides that the gross income of the contributor does not include earnings (at the time they are earned) under the program, and the gross income of the beneficiary does not include contributions to or earnings (at the time they are earned) under the program. However, distributions from the program in excess of amounts contributed (such as interest or dividend earnings) would be included in the gross income of the designated beneficiary at the time the distributions are made. For this purpose, the furnishing of education to a designated beneficiary is considered a distribution. The California Golden State Scholarshare program (discussed below) meets the criteria listed above; therefore, participants in the state Scholarshare program receive these federal tax benefits.

Existing state law in the Education Code established the Golden State Scholarshare Trust. The Scholarshare Investment Board may enter into participation agreements with participants to make payments to the trust for the payment of qualified higher education expenses for a designated beneficiary to attend an institution of higher education. The program establishes an overall maximum investment level for a designated beneficiary. This level is equal to the maximum estimated qualified higher education expenses, as defined, that can be incurred by a beneficiary to obtain a baccalaureate degree at an institution of higher education in California in four years. A penalty is imposed if a participation agreement is canceled for reasons other than death or disability of the beneficiary or in the event the beneficiary receives a scholarship. Pursuant to the participation agreement, the commission invests the pooled trust moneys and any earnings are used by the state to make payments to institutions of higher education on behalf of beneficiaries and to pay for administration costs. The Scholarshare Investment Board is required to adopt regulations to implement the Scholarshare program that are consistent with the requirements for exclusion or deferral from federal taxation. The trust is required to provide an annual listing to the department of all Scholarshare distributions.

Existing state law provides an exclusion from the gross income of a designated beneficiary for contributions to the California Golden Scholarshare program and tax-deferred treatment for earnings on those contributions to the California Golden State Scholarshare program, which approximates the federal law by: (1) deferring from current taxation to the participant or beneficiary earnings from the trust at the time they are earned; (2) providing that distributions from the program in excess of amounts contributed (such as interest, dividends, or capital gains) would be included in the gross income of the designated beneficiary at the time the distributions are made; and (3) providing that the furnishing of education to a designated beneficiary is considered a distribution.

Existing state law, through direct conformity to the federal qualified state tuition program, provides the same tax exclusion and tax deferred treatment to California taxpayers who participate in any other state's qualified state tuition program.

Neither federal nor state laws currently allow a tax credit for contributions to the state Scholarshare program or other qualified state tuition programs.

THIS BILL

This bill would allow individuals a refundable credit of 10% on contributions to any Scholarshare trust in an amount not to exceed \$500 per qualified beneficiary. The credit would be limited to taxpayers with adjusted gross income (AGI) of less than \$200,000. "Qualified beneficiary" would include only those individuals who have been designated in a participation agreement under the Scholarshare program.

This bill specifies that any credit in excess of the taxpayer's tax liability would first be credited against other amounts due, and the balance, upon appropriation by the Legislature, would be refunded to the taxpayer.

IMPLEMENTATION CONSIDERATIONS

This bill would require regular appropriations by the Legislature to pay for the refundable portion of this credit. If sufficient funds were not appropriated to cover all of the refunds due, the department would suspend payment of the refunds until additional funds were appropriated. Interest would have to be paid to refund recipients for the period of time the refund was delayed. This delay would result in additional contacts to the department by refund recipients, which would likely increase departmental costs.

Since the proposed credit is refundable, the credit calculation would need to be shown in the payment section on all personal income tax (PIT) returns except the Form 540 2EZ. This would increase the size of PIT return Forms 540, 540NR, 540X, and potentially the 540A, by one page. This would result in a significant impact on FTB's operations and costs. Adding a page to these returns will slow the processing of the returns and require additional storage space. While the department would work within available space to the extent possible, leasing additional office and file storage space may be necessary.

The bill specifies that the amount of the credit may not exceed \$500 per beneficiary. It is unclear if multiple taxpayers could claim the credit for the same beneficiary. If the intent is for the \$500 per beneficiary credit limit to be per taxpayer, then several taxpayers could set up accounts for the same beneficiary and each claim the credit. Clarification on this issue is needed.

The department does not have any program or other information to verify the annual contributions and earnings of a Golden State Scholarshare Trust. Requiring that the Scholarshare Investment Board report to the department upon request annual contributions and earnings would resolve this concern.

This bill does not provide for the recapture of the credit in the year of cancellation if the participation agreement is canceled or in the year of withdrawal if a withdrawal is not used for qualified higher education expenses.

It is unclear if the credit will be allowed for contributions when the beneficiary's Scholarshare account equals or exceeds the maximum investment level established under the Scholarshare program.

An undetermined number of fraud investigators may be required by the department to verify this credit. Administrative costs of such investigators have not been determined at this time.

TECHNICAL CONSIDERATIONS

The bill defines the term "qualified beneficiary" by reference to the Education Code. However, the Education Code only uses the term "beneficiary." Amendment 1 is provided to make the terms consistent.

LEGISLATIVE HISTORY

Federal Public Law 104-188 (1996), amended by Public Law 105-34 (1997), established an exemption from federal taxation for certain qualified state tuition programs (such as Scholarshare) with tax-deferred treatment of the earnings on contributions made to a qualified state tuition program.

AB 530 (Committee on Higher Education, Stats. 1997, Ch. 851) established the California Golden State Scholarshare program, which, in conformity with the federal qualified state tuition criteria, provided an exemption from state taxation for the Scholarshare program and tax deferred treatment of the earnings on contributions made to the Scholarshare program.

AB 2797 (Machado, Stats. 1998, Ch. 322) allowed, by direct conformity to federal provisions, an exemption from state taxation of a state's qualified state tuition programs and tax deferred treatment of the earnings on contributions made to a state's qualified state tuition program.

SB 1262 (O'Connell, Stats. 1999, Ch. 664) made a number of technical changes to the California Golden State Scholarshare program under the Education Code, including making the Scholarshare Investment Board, which is chaired by the State Treasurer, responsible for administering the program instead of the Student Aid Commission.

AB 2095 (Lempert, 1999/2000), contained similar language as in this bill and died in the Assembly Revenue and Taxation Committee. AB 26 (Nation, 2001/2002) and SB 44 (Alpert, 2001/2002) contain similar language as in this bill and are currently in the Assembly and Senate Revenue and Taxation Committees.

PROGRAM BACKGROUND

Under the Golden State Scholarshare Trust, participants open an account on behalf of a designated beneficiary. The money contributed to the account is placed in a trust that will invest in special investment portfolios chosen by the participant at inception, which are designed to meet the needs of differently aged beneficiaries and different kinds of investors. The program is designed so that earnings in a Scholarshare Account will grow on both a federal and a state tax-deferred basis until the beneficiary is ready to go to college. The funds in the account can be used to pay for qualified higher education expenses at any eligible post-secondary institution throughout the U.S. (and even some outside the U.S.) – including vocational schools.

The Scholarshare program offers four different ways for a participant to choose to invest their contributions. Three involve investments in a combination of stock, bond, and money market mutual funds. Investment returns for the equity-based options will fluctuate and are not guaranteed since the value of accounts invested in these options will go up and down. The fourth option allocates contributions to a guaranteed funding agreement that guarantees the Scholarshare Trust both a return of principal and a fixed minimum rate of return.

OTHER STATES' INFORMATION

Review of Michigan and New York laws found similar tax incentives for educational savings. These states were reviewed because of the similarities between California income tax laws and their tax laws.

Michigan - The Michigan Education Savings Program allows parents, grandparents, relatives or friends to contribute to an account to save for a child's higher education. There are no state income taxes on earnings used to pay for qualified higher education expenses, and account owners can receive an annual state income tax deduction of up to \$5,000 or \$10,000 for joint filers. To receive a tax deduction, contributions must be postmarked by December 31st of each year. There also is a state matching contribution of one dollar for every three dollars contributed by a first-time account owner, up to a maximum state contribution of \$200, with a family income eligibility ceiling of \$80,000 and a beneficiary age limit of six.

New York - The College Choice Tuition Savings Program provides a tax incentive for saving for post-secondary education by allowing account owners to deduct up to \$5,000 (\$10,000 for joint filers) for contributions to all family tuition accounts. The investment earnings on the account are deferred for both federal and state income tax purposes while held in the account. When a withdrawal is made for purposes of paying higher education expenses, the investment earnings are taxable to the beneficiary for federal purposes, but are exempt for New York State purposes.

FISCAL IMPACT

The department's costs to administer this bill are estimated to be \$335,000, including one-time implementation costs of \$212,000, for fiscal year 2001-02 and would increase each year as volumes increase to approximately \$516,000 by 2008. It is estimated that this bill would require the department to incur four additional personnel years (PYs) in 2001-02, increasing to approximately ten PYs by 2008-09. Amendment 2 is provided to suggest language for an appropriation to fund these departmental costs.

ECONOMIC IMPACT

Tax Revenue Estimate

Based on limited data and assumptions discussed below, this bill would result in the following revenue losses under the PITL.

Estimated Revenue Impact of SB 782 As Introduced 2/23/01 [\$ In Millions]		
2001-02	2002-03	2003-04
-\$6	-\$13	-\$20

Estimates assume adequate appropriation by the Legislature to pay refunds resulting from the proposed refundable tax credit. It is assumed the credit limitation of \$500 applies on a per qualified beneficiary basis. According to staff in the author's office, the author's intent is to limit the credit to taxpayers with AGI of \$200,000 for married filing joint and head of household or \$100,000 for all other filing statuses. Estimates above reflect this intent.

Tax Revenue Discussion

The revenue impact of this bill would be determined by the amount of credits generated and reported on tax returns.

The estimate was developed by (1) projecting separately the number of existing accounts at the beginning of each year and the number of new accounts opened during each year, (2) determining how accounts would be distributed by filing status and AGI class of contributors, (3) estimating levels of contributions by adjusted gross income (AGI) class, (4) calculating an average credit for contributors by filing status and AGI class, (5) summing credits generated for all groups, and (6) adjusting for (a) any individual making a contribution on behalf of any qualified beneficiary and (b) the rate at which taxpayers claim the proposed credit on tax returns.

The launch date for the Golden State Scholarshare program was October 4, 1999. As of January 1, 2001, the number of Scholarshare accounts was approximately 27,000. Numbers of accounts qualifying for the credit are projected at 50,300, 83,600, 125,400, 171,200, and 214,200 by year-end 2001 through 2005. Projections assume a certain rate of normal program growth each year. It is assumed that the incentive effect of the proposed tax credit would generate additional new accounts rather than materially increasing the level of contributions to existing accounts. Therefore, an additional rate of growth is applied to reflect an increase in accounts initiated each year by individuals who would qualify for the proposed credit.

Tax return data were used to distribute projected accounts for qualified beneficiaries by filing status and AGI class of contributing taxpayers. Contributions would be sensitive to income levels of participating taxpayers. For various AGI classes, average contributions were estimated at a certain percentage of the mid-point AGI. Percentages ranged from 1% for the lowest AGI class to 3% for the highest. For accounts initiated during a year, contributions were assumed to begin mid-year.

Average contributions were multiplied by the proposed credit percentage of 10% to derive an average credit for both existing and new accounts by filing status and AGI class. Average credit amounts are grown from one year to the next by 3% to represent future growth in the income of eligible taxpayers.

Credits for all groups were summed. Total credits were increased an additional 5% to account for any individual making a contribution on behalf of any qualified beneficiary. Finally, allowances were made for the percentage of credits that would actually be reported on tax returns.

ARGUMENTS/POLICY CONCERNS

The credit would be allowed only if the taxpayer's AGI does not exceed \$200,000, without regard to filing status. Credits that are limited typically have one AGI level for taxpayers using the filing status of married filing separate or single and an AGI level double that amount for married filing joint, head of household, or surviving spouse. As written, a single person and a married couple filing jointly would have the same limit. The limit would be double that amount for married individuals filing separately. The author's staff has indicated this is not the intent and will amend the bill to resolve this concern.

Historically, refundable credits, such as the former state renter's credit and the federal Earned Income Credit, have had significant problems with invalid and fraudulent returns. These problems are aggravated if a refund is made that is later determined to be fraudulent. In such cases the refund commonly cannot be recovered. However, fraud concerns are reduced with this credit due to the narrow criteria for claiming the credit.

This bill does not specify a repeal date. Credits typically are enacted with a repeal date to allow the Legislature to review their effectiveness.

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FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO SB 782
As Introduced February 23, 2001

AMENDMENT 1

On page 2, strike lines 11 through 13 and insert:

(d) For purposes of this section, "qualified beneficiary" has the same meaning as the term "beneficiary" under subdivision (c) of Section 69980 of the Education Code.

AMENDMENT 2

On page 2, lines 19, following "SEC. 2" and before "This act" insert:

(a) There is hereby appropriated from the General Fund for expenditure in the 2001-2002 fiscal year the sum of three hundred sixty thousand dollars (\$335,000) for allocation to the Franchise Tax Board in augmentation of Item 1730-001-0001 of the Budget Act of 2001.

(b) Any funds that are allocated pursuant to subdivision (a) shall be expended by the Franchise Tax Board solely for the purposes of implementation and administration of the Scholarshare Trust Refundable Credit under Section 17053.61 of the Revenue and Taxation Code.

SEC. 3.